Analysis

The EC's communication on digital taxation

Speed read

The European Commission (EC) has set out its plans for 'a fair and efficient tax system in the EU for the digital single market' in a communication to the EU Parliament and the Council. The EC believes the entire international tax framework needs to be reformed and that the OECD's base erosion and profit shifting (BEPS) project did not go far enough in achieving this – neither through the Action 1 review of the so-called 'digital economy', the changes to the definition of permanent establishment (PE) or amendments to the OECD Transfer Pricing (TP) Guidelines. The EC believes this inadequacy can be dealt with through the introduction of the common consolidated corporate tax base (CCCTB) and the extension of the PE concept to 'virtual' PEs. The EC is seemingly prepared to wait for the OECD's impending interim report on the taxation of the digital economy to be released in early 2018. But, if the OECD's report falls short of the EC's expectations, it will implement new short-term measures to tackle the issue: an 'equalisation tax' on turnover, applied to 'untaxed or insufficiently taxed income generated from all internet-based business activities'; a withholding tax on certain payments made to non-resident providers of goods and services ordered online; and an EU-wide advertising tax. Following this, the EC will seek to rewrite the international tax landscape (albeit within the EU) by amending the definition of PE and the use of formulary apportionment to override traditional TP methodologies, through the introduction of the CCCTB. It is questionable whether such EU measures will adequately address the problems identified, or simply increase their complexity and, in the interim at least, the uncertainty, additional cost and compliance burden. Ultimately, the EC wishes to introduce the CCCTB and will use whatever tools it has to strong arm member states down this path.

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The EC has announced that it will drive efforts to fundamentally reform international tax rules to ensure that the digital economy is taxed in a 'fair and growth-friendly way'. The communication adopted by the EC (dated 21 September 2017, see bit.ly/2fcMCXq) states that the international tax framework, despite having worked well for traditional bricks and mortar companies, is ineffective in the digital age. It identifies two critical components used by MNEs to limit the level of profits recognised in the territories in which its customers are located (source territories). This includes:

- exploitation of the shortcomings of the OECD and/or a country's domestic definition of a permanent establishment (PE); and
- exploitation of the subjective nature of the OECD TP guidelines and/or a country's domestic TP regime – in particular, the pricing of intangibles commonly created and exploited by digital businesses.

As such, the EC will push to redefine the concept of a PE (which currently has a focus on physical presence as opposed to economic presence) and for the adoption of alternative methods to the traditional transfer pricing (TP) approach to allocate profits across a group so as to bypass the complexities of pricing hard to value intangibles.

Delivery of reforms through the CCCTB

The EC proposes to deliver these reforms through the common consolidated corporate tax base (CCCTB). The CCCTB proposal was relaunched by the EC in October 2016 and, unlike the original proposal put forward in 2011, will be mandatory for EU groups with a consolidated turnover above €750m. It consists of a single set of rules that multinationals will use to calculate their EU taxable profits, as opposed to different rules and calculations for each member state it does business in.

There are potentially many benefits to the CCCTB. It is expected to ease the compliance burden on tax administrations and MNEs and provide certainty for MNEs with the uniform use of agreed legal terms and provisions across the EU. Fundamentally, losses made in one member state can be set against profits made in another. Tax returns for EU activities need only be filed with the tax authority of the principal company. A multinational's tax base is then distributed among the member states in which it does business, according to a formulary apportionment system. Each member state then taxes its portion of profit at its national corporation tax (CT) rate.

As set out in the communication, the EC believes that further enhancements to the PE rules and formulary apportionment rules currently set out in the CCCTB draft directive can be made to ensure that it adequately covers the digital economy. It is proposed that, in addition to the current PE physical presence indicators, alternative indicators for significant economic presence are required (a 'virtual' PE).

Alongside these changes, the EC is pushing for the development of alternative methods that are not based on existing TP methodologies and traditional business models, but instead focus on identifying and valuing intangible assets, including their contribution to value creation.

Short-term measures

The EC's communication also set out the need for more 'immediate, supplementary and short-term measures'. It suggests the following solutions:

- an equalisation tax on the turnover of digitalised companies;
- withholding tax (WHT) on digital transactions; and
- a levy on revenues generated from the provision of digital services or advertising activity.

1. Equalisation tax

This would be a tax on the turnover (not profit) of digital companies, creditable against corporate income tax or as a separate tax. It would focus on a company's digital, rather than physical, presence in a given country. It is thought that this would bring the CT due by digital companies up to the level of traditional CT in the countries where they generate revenue. The EC has not yet provided information as to how untaxed or insufficiently taxed income would be identified, but one can presume that it will target MNEs with entities in low or no tax territories with insufficient substance – akin to the UK's diverted profits tax (FA 2015 ss 80, 107 and 110). It could lead to countries that oppose the CCCTB, such as Ireland, abolishing CT altogether!

2. Withholding tax

This would be a standalone gross-basis final WHT on certain payments made to non-resident providers of goods and services ordered online. On the face of it, this seems a simple and effective method to allow a source country to tax the revenue of a MNE without or with a limited taxable presence in that country – since it is already used in relation to royalties, management fees, etc. But it may need to be limited to business to business transactions or risk creating complexity and administrative burden were it applied on sales to consumers requiring the consumer to collect small sums of WHT, using intermediaries or placing responsibility onto the MNE to collect and pay over the tax.

3. Levy

This would be a separate charge applied to all transactions concluded with customers located in a country in which a MNE has a significant economic presence but which does not meet the hallmarks of a traditional PE. Equalisation levies are already used by a number of countries in the form of excise duties to ensure equal treatment of foreign and domestic suppliers, particularly as regards taxation of insurance premiums.

It is possible that the same income would become subject to both corporate income tax and the levy. For example, the MNE is likely to be subject to corporate income tax in its residence country but unlikely to be able to credit the levy imposed by the source country against its CT liability. Again, this is not dissimilar to the UK's diverted profits tax (DPT) – a punitive tax rate applied by a tax administration to frustrate the activities of a MNE through the artificial avoidance of a PE.

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However, unlike the UK's DPT, the EC's proposal is shortterm, but would fundamentally reshape the tax landscape across the EU. In doing so, there is significant risk of upheaval of the existing system, potentially creating inconsistent outcomes and not achieving its objective of levelling the playing field for traditional and digital business models (for example, the equalisation tax, WHT or levy would be imposed on e-books sold online from a MNE, such as Amazon, but not on paper books sold online from the publisher).

Is the creation of a separate tax system for the digital economy (the digital single market) necessary?

The OECD in the BEPS Action 1 final report concluded that the digital economy cannot be ringfenced for tax purposes. Instead, the OECD focused on identifying key features of the digital economy that give rise to BEPS strategies, in particular identifying the the application of TP methodologies and the definition of a PE as the primary culprits.

The OECD addressed the TP concerns by updating its TP Guidelines in July 2017 to include the recommendations contained in the BEPS Action 8, which focused on the pricing of intangibles (critical to many digital businesses); and updating the definition of PE contained in double tax agreements (DTAs) through the conclusion of the multilateral instrument in 2016 to restrict the use of the preparatory and auxiliary exceptions (i.e. targeting Amazon).

Updated OECD TP Guidelines

It is not clear why the EC believes the updated OECD TP Guidelines arising from the BEPS Actions 8–10 recommendations do not address the issue of allocating profits to the country in which value is created, despite the OECD concluding that the recent revisions will, in most cases, yield an appropriate allocation of returns derived by multinationals from the exploitation of intangibles (which includes many digital businesses). If the current guidance is sufficient to protect member states' tax bases, there is no need to inject further complexity into a multifarious international tax system with the formulary apportionment system.

It is the authors' view that the changes to the TP Guidelines, including the concept of 'DEMPE' functions (development, enhancement, maintenance, protection and exploitation) and the implicit preference to use the OECD's profit split method (PSM) to ensure profits are allocated in line with the value of each associated company's contributions, work well in addressing some of the taxation challenges posed by the digital economy.

An MNE's DEMPE functions should become its focus in pricing transactions between associated companies, such that they are only compensated on the basis of the value they contribute to an intangible asset through functions performed, assets used and risks assumed in the DEMPE of intangibles. A company must be able to exercise control over the risk and have the financial capacity to assume risk; it is not enough to contractually assume a specific risk. Nor is it enough that it merely owns an intangible asset.

With a focus on DEMPE and application of the PSM, aspects of the formulary apportionment system may be replicated in transactions between associated companies or branches. In applying the PSM, the first step is to identify the total consolidated profit from a MNEs transaction and then to split that profit between the associated companies based on their individual economic contributions to the transaction. The profits are split based on factors, such as assets, capital (e.g. intangibles) and costs. The determination of the appropriate profit splitting factor(s) should reflect the key contributions to value made in relation to the transaction in question. Although, the authors note that the current OECD guidance on application of the PSM is lacking in sufficient detail and industry examples and look forward to reviewing the proposed revised guidance expected to be published by the

OECD in November 2017.

Of course, these aspects only address the allocation of profits between digital companies that derive value from intangibles. This does not necessarily apply to companies such as Amazon or Google, which limit taxation in territories in which they make sales by avoiding creating a PE.

Updated OECD model PE definition

The OECD, through BEPS Action 7, amended the current model definition of a PE to capture MNEs (whether traditional or digital) from structuring their operations to avoid a PE in the source country. In order to be effective, over 100 countries have signed a multilateral instrument to alter their DTAs. However, they will also need to update their domestic legislation. The UK, for example, has indicated that it will not be changing its PE definition since its introduction of the DPT.

Despite these changes, the current model definition of PE still allows companies to trade internationally without being exposed to source taxation, other than in circumstances where they exceed a defined physical presence. The EC is proposing to extend the definition of a PE such that one will be created in cases where a MNE has a significant economic presence (i.e. significant sales) in the source country.

> Jumping the gun ... is not the way to tackle such an important overhaul of the tax system

Amendments to the definition of a PE need to go far enough to give taxing rights to the source country in respect of digital transactions – otherwise, the TP regime will never come into play and it is irrelevant whether or not the TP regime is fit for digital business. Nonetheless, if the EC goes ahead with such PE reforms, a high de minimis turnover threshold will be required to prevent an otherwise significant increase in compliance burdens and cross-border tax disputes that will surely follow the introduction of economic indicators into the PE definition.

It is the authors' view that whilst the recent OECD changes to the model PE definition provide some additional power to the tax administration of a source country to tax revenues generated by MNEs from customers in that country, more needs to be done, whether this is through the introduction of an equalisation tax, a levy or a significant presence test (i.e. a 'virtual PE') for determining whether a PE exists. Moreover, the DTA changes will only be effective if the source country updates its domestic law definition of a PE (since a DTA can't create a PE if one does not exist under domestic law).

Conclusion

One might argue the EC is jumping the gun. The OECD is expected to complete its work on ensuring fair taxation of the digital economy with an interim report in April 2018. The OECD's consultation on revised guidance for application of the PSM only closed in September 2017, with a public consultation on the revised guidance expected to be issued in November 2017. The authors' view is that the EC does not care much for the OECD's conclusions (as evidenced by the introduction of the EU Anti-Tax Avoidance Directive, which extends much of the OECD BEPS conclusions). The EC is seemingly determined to rewrite the tax landscape of the EU, positioning it as a super state, removing internal competition with the introduction of the CCCTB and capitalising on the 'fair share of tax' movement to become the United States of Europe. Whilst the CCCTB may address some of the tax concerns of the digital economy, it will do so at the cost of removing competition. To remove competition between countries that are not equal is dangerous: member states are vastly different due to matters that the EU cannot influence or control, such as size, proximity to the sea, weather, language, education and unemployment. Furthermore, the EC itself admits the proposals are potentially incompatible with state aid rules, existing double tax treaties and free trade agreements.

Jumping the gun, in the same way the UK did by introducing the DPT, is not the way to tackle such an important overhaul of the tax system. There is no first mover advantage and making significant amendments to fundamental concepts, such as PE, requires international consensus, rather than political one-upmanship, to prevent rules being introduced that unfairly affect the large majority of businesses when the real target is the US technology companies. To effect long-term change, international consensus is required to successfully reform the taxation of the digital economy. The OECD BEPS work offers a strong basis for international reform and should be built upon and it should be accepted that this may take some time. ■

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